# Tax Deductions and Depreciation

## Tennessee Department of Agriculture, Division of Forestry

Landowners who can demonstrate a profit motive can deduct 1) capital costs (which form the cost basis of the property); 2) currently deductible expenditures for management and protection; 3) costs of sale.

Capitalized costs include items that are being depreciated, and costs that must remain in the capital account and be deducted from proceeds when the timber is sold. The latter include acquisition costs (cruise, survey, legal fees, etc.), construction of permanent roads, and reforestation costs not amortized under the special IRS 7-year amortization provision. Sale costs are also subtracted from timber sale revenue.

**Currently deductible** expenses can be deducted in the year they occur. To be deductible, expenses must be "ordinary and necessary costs" related to making a profit. These include carrying charges (property taxes and interest) and operating costs not related to a capital project: consultant and professional fees, hired labor, non-commercial silvicultural expenses, protection costs, travel expenses necessary for managing the land for a profit, tools with a life of less than a year and costing less than $100, routine equipment maintenance, etc.

Filing status determines how currently deductible expenditures are treated:

- An investor can deduct expenses which, when aggregated with all other "miscellaneous itemized deductions" exceed a 2%-of-adjusted gross income floor from income from any source. Exceptions are property taxes, which are fully deductible against income from any source, and interest, which is deductible against net investment income (2% floor does not apply). Alternatively, investors can capitalize expenses (see below). In this way expenses can be recovered when the timber is sold.
- A "passive" business manager can deduct all currently deductible expenses, but only against passive income; unused deductions can be carried forward indefinitely and applied to future passive income
- An "active" business manager can deduct all currently deductible expenses from income from any source.

See Forestry information sheet, *"Filing Status for Timber Sales"* for criteria.

Landowners can elect to capitalize carrying charges and operating costs. Carrying charges can be elected annually, but election to capitalize operating costs (such as timber stand improvement) must remain in effect until the management is completed. Carrying charges cannot be capitalized if the land is developed (built on), nor can they be capitalized in any year the land produces income.

Investors report deductions (above 2% floor) on Form 1040 Schedule A; businesses report deductions on Schedule C, and farmers on Schedule F. Notify the IRS of the election to capitalize carrying charges and operating expenses on a plain piece of paper.

**Depreciation** is accomplished by annually deducting the allowable amount for that year from both gross income and the capital account. Depreciable property includes office equipment, vehicles, tractors and similar equipment, tools with a life greater than a year and costing more than $100, fences, bridges, culverts, buildings, temporary roads, and the surfaces of permanent roads.

Property is depreciated according to a schedule set by the IRS for that item. Tables are found in IRS Publication 946, How to Depreciate Property. The most commonly used set of IRS depreciation tables is the Modified Accelerated Cost Recovery System, or MACRS. To select a table, you must know the placed-in-service date, the convention used for that item, and the depreciation method.

The most common methods are the 200% declining balance over the General Depreciation System recovery period (for non-farm) and the 150% declining balance over the GDS period method (for farms). See IRS tables in Publication 946.

"Convention" can be mid-year, mid-quarter or mid-month, but usually mid-year. Under the half-year convention, only half a year's deduction is taken in the first and last years; this stretches the basis recovery period over an added tax year. *(Note: If more than 40% of an item that would normally be depreciated using the half-year convention is placed in service during the fourth quarter, it must be depreciated using the half-quarter convention.)*

Recovery periods:

- Basis recovered over **five** years: computers, light trucks, portable sawmills, copiers, logging machinery and road building equipment used by loggers and sawmillers for their own account
- Basis recovered over **seven** years: office furniture and equipment, farm fences
- Basis recovered over **15** years: bridges, culverts, non-farm fences, temporary roads, permanent road surfaces

Under Section 179, up to $25,000 of expenditures (after 2002) can be deducted in the year the money was spent. For example, if you purchase a truck for $20,000 you can deduct it entirely in the year purchased without having to amortize it over a five–year period. An item must be used more than 50% in the business to qualify for Section 179 treatment. Elect Section 179 treatment on Form 4562.

*Listed items* are things commonly used both at home and in the business. Listed items include cars, computers, cell phones, etc. Deductions must be in proportion to business versus personal use. For example, if a truck is used 60% for the business, the annual deduction listed in the IRS tables must be multiplied by 0.6. If an item is used in the business less than half the time, it can no longer be depreciated by the 200% or 150% methods, and instead must be depreciated using the straight-line method (see IRS tables). It is important to keep detailed records of use of listed items.

Maintenance is a deductible expense, but repairs that increase the value or lengthen the life of equipment must be capitalized.

A "units of production" method may be elected for temporary roads. Amortized costs are allocated proportionate to the units removed in a given year divided by the total number of units removed.

You cannot capitalize both road construction and the equipment used in construction. Equipment amortization for the period it is used must be entered into the capital account for the road.

Assets depreciated using the same method and convention can be grouped together for accounting purposes. Write "general asset allocation made under Section 168(i)4" on the top of Form 4562.

If you sell depreciated property, the amount received for the depreciated item, up to the depreciated amount, is recaptured as ordinary income; money you receive above the depreciated amount is taxed as a capital gain.

Use Form 4562 section II to classify property and take the first deduction for property placed in service the previous year; use section III for deductions for property placed in service during prior years; use section V to document business use and calculate deductions for listed property.

See IRS publications 946 "How to Depreciate Property", 225 "Farmers Tax Guide", and 334 "Tax Guide for Small Business".

*This publication is educational and is not intended to serve as specific tax advice or as a substitute for the services of an accountant.*

*Draft version 8-12-02*